

**Motion for HB 2 Section A: Department of Revenue Budget**

**DP 9000 - Enhanced Tax Compliance to Partially Finance Business Equipment Tax Reductions**

This decision package would add 10.00 FTE and a total of \$1,617,514 general fund in the 2011 biennium to enhance the Business and Income Taxes Division compliance staff with a project on pass-through entity compliance with a focus on non-filing and underreporting by non-resident owners.

The pass-through enhanced tax compliance project is conservatively estimated to increase general fund tax revenue collections by \$3.30 million in FY2010, \$5.30 million in FY2011, and \$5.60 million annually in subsequent years.

The purpose of this proposal is to provide partial funding of business equipment tax reductions. Thus, the difference between the estimated revenues and the cost of the proposal would generate net annual revenue that would be used to offset these tax reductions in the amount of \$2.5 million in FY2010, \$4.5 million in FY2011, and \$4.8 million in subsequent years.

The amendment will address staffing deficiencies in the compliance programs related to pass-through entities. Montana as well as many other states have long recognized that our compliance programs have failed to keep up with the sheer growth of pass-through entity returns and income, the number of owners of such entities who are responsible for the payment of taxes earned by these business and the complexity of the issues related to these entities.

The growth in pass-through entities alone justifies the need for additional staffing and funding. From 2000 through 2008 the number of partnership and S-corporations returns grew from 24,700 returns to 45,700—an increase of 21,000 returns or 85%. More significantly, from 2002 to 2006, *reported* income for these entities increased by an estimated 127%.

Ensuring pass-through entity tax compliance is a more complex challenge than is the case of either regular individual income tax or corporate tax compliance. Because the owners of pass through entities are responsible for the tax, verifying that income taxes are being properly paid by these entities is at least a two-step process. First, the income must be accounted for at the business entity level, and secondly the income must be reported and the tax ultimately paid by the owners. Ultimately, 45,700 returns in 2008 can translate into ensuring that hundreds of thousands of owners have filed and paid the correct amount of tax. In practice, non-resident owners are responsible for the greatest share of non-filing and underreporting of this income.

To provide a contrast in the growth of pass-through entities returns, C-corporations have grown from 17,000 to 18,000—an increase of 1,000 returns or only 6%. The department's C-corporation audit program is staffed with 14 auditors and has produced over the last biennium roughly \$33.2 million in audit collections.

Using the C-corporation audit program as a basis, the request for 10 FTE—in addition to the current 2.5 FTE already devoted to this area—is a very modest proposal. Shifting FTE from other compliance projects is not a viable alternative because other projects are also highly productive. Reducing FTE in other project areas will merely create new compliance problems for other types of income. Tax compliance gaps can be closed only by maintaining sufficient efforts in all major problem areas.

Table E-1

**Component Amount and Share of Total Schedule E Income**  
**Tax Years 2002 - 2006**

Type of Income	TY2002	TY2003	TY2004	TY2005	TY2006	% Change 2002 - 2006
Rents and Royalties	223,170,776	226,117,746	286,900,438	340,344,987	322,099,149	44.3%
<b>Partnerships and S Corporations</b>	<b>797,155,048</b>	<b>747,878,419</b>	<b>850,667,364</b>	<b>1,496,624,371</b>	<b>1,809,145,585</b>	<b>127.0%</b>
Estates and Trusts	29,373,432	28,933,026	30,720,732	48,215,228	55,968,349	90.5%
Farm Rental Income	32,453,941	45,199,877	37,881,278	32,508,684	40,832,352	25.8%
<b>Total Schedule E Income</b>	<b>1,082,153,197</b>	<b>1,048,129,068</b>	<b>1,206,169,812</b>	<b>1,917,693,270</b>	<b>2,228,045,435</b>	<b>105.9%</b>

**Share of Total Schedule E Income**

Rents and Royalties	20.6%	21.6%	23.8%	17.7%	14.5%
Partnerships and S Corporations	73.7%	71.4%	70.5%	78.0%	81.2%
Estates and Trusts	2.7%	2.8%	2.5%	2.5%	2.5%
Farm Rental Income	3.0%	4.3%	3.1%	1.7%	1.8%
<b>Total Schedule E Income</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>